D.P.U. 93-167-A

Investigation by the Department on its own motion, pursuant to G.L. c. 164, § 76 and § 96, for the purpose of establishing guidelines and standards for acquisitions and mergers of utilities, and evaluating proposals regarding the recovery of costs for such activities.

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I. INTRODUCTION

A. Procedural History

On September 22, 1993, the Department of Public Utilities ("Department"), on its own motion, opened an investigation for the purpose of considering guidelines and standards for mergers or acquisitions of utilities, and evaluating proposals regarding the recovery of costs for such activities. The Department noted that it intended to focus its investigation on the following questions: (1) what factors should be considered in determining whether a proposed merger or acquisition is in the public interest; (2) what impact would the allowance or disallowance of acquisition premiums have on potential mergers or acquisitions; (3) should the Department reconsider its position on the recovery of acquisition premiums; (4) what costs should be included in an acquisition premium; (5) what is the proper accounting treatment of such costs; (6) what additional factors/costs should be considered in reviewing a merger or acquisition proposal; and (7) what is the impact of different regulatory policies on mergers or acquisitions. The investigation was docketed as D.P.U. 93-167.

Pursuant to a notice duly issued, a procedural conference was held on October 19, 1993 at the Department's offices. On December 13, 1993, the hearing officer issued a memorandum requesting that all interested parties file written comments in response to the list of questions posed by the Department in its Order of September 22 opening this investigation, and one additional question, whether there is anything in the Department's regulatory scheme that would impede or discourage the occurrence of an appropriate acquisition or merger.

Initial comments were received on January 28, 1994 from Bay State Gas Company

("Bay State"), Boston Edison Company ("BECo"), Boston Gas Company and Eastern Enterprises (collectively "Boston Gas/EE"), Cambridge Electric Light Company, Canal Electric Company, Commonwealth Electric Company and Commonwealth Gas Company (collectively "COM/Energy"), Colonial Gas Company ("Colonial"), the Executive Office of Economic Affairs of the Commonwealth, Division of Energy Resources ("DOER"), Eastern Edison Company ("EECo"), Senator Mark Montigny, Massachusetts Electric Company ("MECo"), Massachusetts Municipal Wholesale Electric Company and Municipal Electric Association of Massachusetts (collectively "MMWEC/MEAM"), United Steelworkers of America, AFL-CIO, International Brotherhood of Electrical Workers, AFL-CIO and Utility Workers of America, AFL-CIO (collectively "Unions"), and Western Massachusetts Electric Company ("WMECo").[1] Reply comments were received on February 16, 1994 from the Attorney General of the Commonwealth ("Attorney General"), BECo, Berkshire Gas Company ("Berkshire"), Boston Gas/EE, Colonial, DOER, COM/Energy, Essex County Gas Company ("Essex"), Fall River Gas Company ("Fall River"), MECo, MMWEC/MEAM, Milford Water Company ("Milford"), North Attleboro Gas Company ("North Attleboro"), and Unions.[2]

On May 2, 1994, the hearing officer issued a memorandum requesting that all

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[1] For the purpose of citing, the initial comments will be referred to using the commenter's name and page number being cited. For example, Attorney General at 1.

[2] For the purpose of citing, the reply comments will be referred to using the commenter's name, reply and page number being cited. For example, Attorney General Reply at 1.

interested parties provide written comments by May 16, 1994 on the following four additional issues: (1) the use of an intangible plant account to account for acquisition premiums; (2) the definition of acquisition premium; (3) whether shareholders are compensated for the difference between the book value and pre-merger market value of a firm through the return on equity; and (4) utility plans which could serve as a deterrent to possible takeovers. In the May 2nd memorandum, the Department noted that following consideration and analysis of the comments it would issue a policy statement and conclude its investigation. Comments on these four and additional issues were filed by the Attorney General, Bay State, BECo, Berkshire, Boston Gas/EE, Colonial, COM/Energy, DOER, Essex, Fall River, MECo, Massachusetts American Water Company ("Mass American"), Salisbury Water Supply Company ("Salisbury"), MMWEC/MEAM, the Unions, and WMECo.[3]

B. Background

Mergers or acquisitions issues have been raised in two recent rate proceedings. First, in Cambridge Electric Light Company, D.P.U. 92-250 (1993), DOER, an intervenor in that case, sought information from Cambridge Electric Light Company regarding possible economies under certain hypothetical scenarios relating to mergers, consolidations or joint endeavors with other electric utilities. Id. at 4. Although DOER's request was denied on the ground that the information it sought fell outside the scope of a general rate case, the

[3] For the purpose of citing, the commenters' response will be referred to using the commenter's name, 5/16/94 Comments and the page number being cited. For example, Attorney General 5/16/94 Comments at 1.

Department noted that those issues are of "considerable and continuing interest." Id. at 5, 6. In Boston Gas Company, D.P.U. 93-60 (1993), Boston Gas submitted a document entitled "Consolidating the Massachusetts Gas Industry" ("Boston Gas White Paper") in response to an information request from DOE R.[4] The White Paper concluded that there are institutional inefficiencies in the gas industry in Massachusetts and recommended that there be a consolidation of the industry. Boston Gas White Paper at 14, 15.

In the instant proceeding, in light of concerns over high utility rates which in part may be the result of duplicative facilities, functions, and services among Massachusetts utilities, the Department has sought to reexamine its current policy towards mergers or acquisitions and determine whether the public interest may better be served by specific policy changes that enhance efficient delivery of utility services in Massachusetts. We note that the issues raised by the Department in this proceeding are an important part of a multitude of issues the Department must consider to achieve its ultimate regulatory goal, which is to ensure that the utilities subject to the Department's jurisdiction provide safe and reliable service at the lowest possible cost to society. As we indicate below, the Department believes that cost-effective mergers are one of several means by which utilities may be able to reduce their cost of service, improve service reliability, and enhance their financial strength.

Both the natural gas and the electric utility industries are in the midst of significant change. Recent policy changes at the federal level and in Massachusetts have led to

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[4] The Boston Gas White Paper was marked and moved into evidence in the D.P.U. 93-60 proceeding as Exhibit DOE R-1. That exhibit is incorporated by reference in this proceeding.

increased competition between and within the utility sector. Changes in the structure of electricity and gas markets may alter the efficient scale of operations for firms in these industries and may cause a movement towards consolidation in some instances.

The Department is interested in all measures that will promote efficiency by discouraging waste, increasing productivity, and improving service reliability in order to lower costs for all customers. For example, cost reduction benefits have been achieved through participation in regional cooperative purchasing and load management and power pooling agreements, such as the Mansfield Consortium and the New England Power Pool. See Mansfield Consortium, D.P.U. 93-187/188/189/190 (1994); G.L. c. 164A, §§ 1-27. The changes that are presently taking place in both electric and gas markets may provide additional opportunities for utilities to identify ways to achieve cost and rate reductions.

In an increasingly competitive market, mergers or acquisitions may represent one of many measures that could achieve savings, efficiencies, increased reliability, and better quality of service for Massachusetts utilities. As stated in Cambridge Electric Light Company, D.P.U. 92-250, at 6-7 (1993), the Department expects all utilities to explore thoroughly all cost-savings measures and potential opportunities to achieve efficiencies of all kinds. These opportunities will vary from company to company, and from time to time, but should be matters for continuing attention and alertness by a company's senior management and directors. Evidence of success in these areas will be expected in rate cases. The Department reiterates its position that prudent and effective management practice requires each utility's management to be vigilant to seize all reasonable opportunities for cost reductions, including those involving some form of consolidation, whenever and wherever

available. Id. at 7.

In the sections that follow, the Department will articulate its policy regarding mergers or acquisitions. In reaching its overall policy, the Department will address specifically (1) the standard of review by which it will evaluate a proposed merger or acquisition, (2) the determination and recoverability of acquisition premiums, and (3) other issues related to mergers or acquisitions.

II. TREATMENT OF ACQUISITION PREMIUMS UNDER THE STATUTORY STANDARD

A. Introduction

Statute provides the Department's standard for judging the propriety of mergers and acquisitions. G.L. c. 164, § 96. Section 96 permits companies subject to Chapter 164 to engage in merger or acquisition under the preconditions there stated. The principle statutory precondition pertinent here is that the Department determine that the transaction to be consistent with the public interest. Id. In Boston Edison Company, D.P.U. 850, p. 8 (1983), the Department construed § 96's standard of consistency with the public interest ("consistency standard") as requiring a balancing of the costs and countervailing benefits attendant on any proposed merger or acquisition.

Merger proposals that envision earning an acquisition premium have heretofore been regarded by the Department as per se impermissible. In and of themselves, acquisition premiums do represent a cost or disadvantage to the ratepaying public. The theoretical basis, however, for allowing a premium is that a transaction otherwise in the public interest would not occur, absent premium allowance, and further that the costs or disadvantages represented

by the premium are warranted by the benefits thereby captured.

For the reasons set forth in the ensuing discussion, the Department will no longer follow a rule of per se disallowance. Merger proposals that include an acquisition premium will henceforth be judged on a case-by-case basis. The question whether an acquisition premium should be allowed in a specific case will now be answered as part of the general balancing or reckoning of cost and benefit conducted under the § 96 consistency standard. Under the consistency standard, a company proposing a merger or acquisition with or without an acquisition premium must, as a practical matter, show that the costs or disadvantages of the transaction are accompanied by benefits that warrant their allowance. Thus, allowance or disallowance of an acquisition premium would be one part of the cost/benefit analysis under the § 96 consistency enquiry.

The public interest judgment the Department is required to make under § 96 must rest on a record that quantifies costs and benefits to the extent such a judgment is susceptible of quantification. This admonition is particularly apt where allowance of an acquisition premium is sought. A § 96 petitioner, that expects to avoid an adverse result such as that seen in D.P.U. 850, cannot rest its case on mere generalities, but must instead demonstrate benefits that justify the costs, including the cost of any premium sought.

B. Factors to be considered in determining whether a proposal is consistent with the public interest

Commenters suggested that the Department consider: (1) the impact of a proposed merger or acquisition on rates (Attorney General at 15; Bay State at 2-3; Boston Gas/EE at 28-32; DOER at 13-14; MECo at 3; WMECo at 1); (2) the impact of a proposed merger

or acquisition on the quality of service (Attorney General at 15; Bay State at 2-3; BECo at 2-4; Boston Gas/EE at 28-32; DOER at 13-14; EECo at 6-7; MECo at 3; WMECo at 1); (3) net savings resulting from a proposed merger or acquisition (Attorney General at 16; Bay State at 2-3; BECO at 2; Berkshire at 8; Colonial at 7-11; DOER at 12-13; EECo at 6); (4) the impact of a proposed consolidation on competition (Attorney General at 15; Bay State at 2-3; Boston Gas/EE at 28-32; Colonial at 7-11; MECo at 3; Milford Reply at 2); (5) the financial integrity of the post-merger entity (Attorney General at 15; Bay State at 2-3; Colonial at 7; DOER at 15-17; MECo at 3; WMECo at 1); (6) fairness of the distribution of benefits resulting from a proposed merger or acquisition between stockholders and ratepayers (Boston Gas/EE at 15-17; Colonial at 5-7; DOER at 15-17; EECo at 6-7; MECo at 3; Milford Reply at 2); (7) the societal cost of any jobs eliminated due to mergers or acquisitions (Unions at 3); (8) the impact of a proposed merger or acquisition on economic development (WMECo at 1); and (9) alternatives to mergers or acquisitions (BECo at 2-4; Colonial at 7-11).

WMECo, BECo, MECo, the Attorney General, MMWEC, and Milford suggest that the Department should be flexible in its review of proposed mergers or acquisitions. (WMECo at 1; BECo at 2; MECo at 13; Attorney General at 16; MMWEC at 10; Milford at 1). These commenters recommend that the specific factors used to determine if a proposal is consistent with the public interest should be made on a case-by case basis (id.). In addition, Milford states that the small size of investor-owned water utilities in Massachusetts, in combination with federal mandates brought about by the Safe Drinking Water Act, create a "unique" set for circumstances of water companies (Milford at 1). In recognition of these

considerations, Milford advocates that the Department treat proposals for mergers or acquisitions of water companies differently from those of gas and electric companies (id.).

In evaluating a § 96 petition, the Department would consider the potential gains and losses in a proposed merger and acquisition to determine whether the proposed transaction is in the public interest. This undertaking involves consideration of the special factors surrounding an individual proposal. Although we do not here establish an exhaustive list of specific factors that we will use to assess whether a proposed transaction is consistent with the public interest, we note that many of the factors presented by the commenters in this proceeding, such as those just discussed, would likely be considered by the Department in its review of a proposed merger or acquisition.

III. ACQUISITION PREMIUM

A. Department Precedent

An acquisition premium is generally defined as representing the difference between the purchase price paid by a utility to acquire plant that previously had been placed into service and the net depreciated cost of the acquired plant to the previous owner. To establish the context in which the Department's current policy on acquisition premiums has been reviewed, we briefly examine our past policy.

Most mergers or acquisitions that have occurred in Massachusetts have involved affiliated companies where assets and liabilities were combined into a single entity. In these cases, consolidations were achieved either by a sale of assets at a price equal to book value or by exchange of stock. Because these transactions did not result in a difference between purchase price and original book value, no acquisition premium was realized. See, e.g.,

Hingham Water Company, D.P.U. 89-134, at 10 (1989); Massachusetts Electric Company, D.P.U. 1457, at 4 (1983); Brockton Edison Company, D.P.U. 19552, at 4 (1978); New Bedford Gas and Edison Light Company, D.P.U. 15084, at 2 (1965); Worcester County Electric Company, D.P.U. 13473, at 3-4 (1960); New England Power Company, D.P.U. 8391, at 4 (1948); Worcester Gas Light Company, D.P.U. 3883 (1931); Boston Consolidated Gas Company, D.P.U. 627/628 (1922). Likewise, in many mergers involving unaffiliated entities, the mergers or transfers of utility property were also based on net book value.[5] Fitchburg Gas and Electric Light Company, D.P.U. 18681, at 17-18 (1976).

A merger or consolidation may also occur through a pooling of interests by two or more utilities. Under this approach, the equity interests of the two or more merging entities are combined. Bay State Gas Company, D.P.U. 19886, at 13 (1979).[6] Under generally accepted accounting principles, a combination of companies using pooling accounting may only occur if specific criteria are met by the combining entities. Because there is no asset distribution under pooling accounting, no acquisition premium is realized. Bay State Gas,

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[5] In those mergers involving the acquisition of municipal electric systems, the Department has found that the purchase price paid by the acquiring utility fairly represented the net book value of the acquired systems. Lee Electric Company, D.P.U. 4211 (1931); Lee Electric Company, D.P.U. 4019 (1930). Therefore, no acquisition premiums have been realized in transactions involving the acquisition of a municipal system.

[6] D.P.U. 19886 was a Section 17A proceeding. While the Department has expressly disapproved the use of § 17A for merger purposes, D.P.U. 19886 concerned the creation of a subsidiary organized for the purpose of acquiring Northern Utilities, a New Hampshire utility, and is therefore distinguishable from other efforts to use Section 17A as a means to merge utilities. Compare, Springfield Gas Light Company, D.P.U. 17139, at 2-3 (1971); Fitchburg Gas and Electric Light Company, D.P.U. 16113-B, at 2-3 (1970).

D.P.U. 19886, at 14.

Despite this general practice, some mergers or consolidations did involve an acquisition price that differed from the net book value of the assets of the acquired utility, thus producing an acquisition premium. The Department policy has heretofore refused to recognize these premiums for ratemaking purposes. See Boston Gas Company, D.P.U. 88-67, Phase I, at 26-27 (1988); Springfield Gas Light Company, D.P.U. 17139, at 3 (1971); Boston Edison Company v. Board of Assessors of Boston, 402 Mass. 1, 15 (1988). From the inception of utility regulation in Massachusetts, the Department and its predecessors have determined utility rates based on capitalization and investment, and not on other measures of cost. Report of the Special Commission on Control and Conduct of Public Utilities (House Document No. 1200), at 230-231 (March 3, 1930).

In those cases where a merger resulted in an acquisition premium, the Department has usually required the acquiring utility to book any difference between the acquisition price and net book value of the acquired company to Account 217 (Surplus Invested in Plant). Fitchburg Gas and Electric Light Company, D.P.U. 17636, at 4 (1973); Boston Edison Company/Boston Gas Company, D.P.U. 17444, at 7 (1972).[7] See also Berkshire Gas Company, D.P.U. 12479 (1958); Pittsfield Coal Gas Company, D.P.U. 11018 (1954).

Nevertheless, the Department has in several instances departed from this standard practice and permitted the acquiring utility to establish on its books an intangible plant

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[7] In some instances, such as when use of this method would produce a negative account balance, the difference between acquisition price and book value would be recorded against retained earnings. Boston Gas Company/Boston Edison Company, D.P.U. 17444, at 7 (1972).

account to record the difference between the purchase price and net book value of utility assets. In these cases, the excess of purchase price over net book value of assets booked to Account 303 (Intangible Plant), and the resulting premium was, in general, to be amortized over the life of the acquired assets. Bay State Gas Company, D.P.U. 17726, at 5-6 (1973); Boston Gas Company, D.P.U. 17574, at 11 (1973); Boston Gas Company, D.P.U. 17138 at 7-8 (1971). However, in each of these cases, the acquiring company specifically pledged that it would not include the premium in rate base, and would not propose cost of service treatment for amortization.[8]

B. Positions of Commenters

1. Recoverability of Acquisition Premiums

The comments received by the Department regarding the rate recovery of acquisition premiums can be grouped into three categories. First were those favoring recovery; second, those opposing recovery; and third, those proposing case-by-case examination.

Several commenters propose that the Department's current policy was equitable, and therefore opposed recovery of acquisition premiums (Attorney General Reply at 19; MMWEC/MEAM at 12; EECo at 14-19; Essex Reply at 9; Unions at 5). According to the Attorney General, departing from the Department's current policy would result in customers paying more than once for investment and provide stockholders with a vehicle to circumvent

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[8] The Boston Gas White Paper suggests that intangible plant accounting is the only method used by the Department to account for mergers. The White Paper further claims that the Department refused in D.P.U. 17574 to allow rate recovery of a proposed acquisition adjustment (D.P.U. 93-60 [1993], Exh. DOER-1, at 8). The White Paper misconstrues Department precedent. See D.P.U. 17574, at 10-11; D.P.U. 17138, at 7-8.

the original cost basis of the Department's ratemaking scheme (Attorney General Reply at 12). The Unions contend that the Department's current policy militates against imprudent merger activity and that the benefits of cost savings associated with mergers would provide adequate compensation (Unions at 5, 7). MMWEC/MEAM contends that because it is the stockholders who decide whether to embark on a merger, they should be the ones to bear the costs associated with that decision (MMWEC/MEAM Reply at 5-6).[9]

EECo contends that rate base treatment of an acquisition premium would increase rates without any real savings to customers (EECo at 14-19). Rather, EECo proposes that sharing the savings associated with a merger between customers and shareholders would itself provide sufficient incentives for the involved utilities to embark on the merger and accrue benefits to both parties (EECo at 19-20). Essex argues that proceedings intended to determine the recoverability of acquisition premiums would be unnecessary and costly. Essex proposes that market forces be allowed to make those determinations (Essex Reply at 9). The Unions would further require that cooperative purchasing and load management measures be exhausted before merger proposals are considered, with a direct pass through of actual cost savings to ratepayers (Unions at 5).

Boston Gas/EE supports a change in Department policy that would permit recovery of all acquisition premiums, provided that customers receive benefits associated with the merger in excess of the annual recovery of the acquisition premium (Boston Gas/EE at 50). Boston

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[9] In addition, MMWEC/MEAM contends that the Department's current policy is in harmony with the provisions of G.L. c. 164, § 43, which prohibit the inclusion of an acquisition premium as part of the purchase price by a municipality of a privately-owned company (MMWEC/MEAM at 15-16).

Gas/EE argues that the Department's current policy discourages mergers and deprives ratepayers of the benefits associated with mergers (id. at 33). Boston Gas/EE contends that acquisition premiums should be considered a necessary cost associated with generating the cost savings and lower rates that are claimed would result from mergers (id. at 4).

Bay State, Berkshire, Colonial, COM/Energy, DOER, Fall River, Mass-American/Salisbury, Milford and WMECo propose that recovery of premiums should be determined on a case-by-case basis (Bay State at 6; Berkshire at 2; Colonial at 4-5; ComEnergy at 38, 127-128; DOER at 21; Fall River Reply at 2-3; Mass-American/Salisbury 5/16/94 Comments at 1; Milford Reply at 2; WMECo at 2). Colonial and Fall River reason that the adoption of a blanket rule favoring recovery of acquisition premiums would leave customers at risk for the failure of any savings to materialize, and would be worse than the present blanket rule against such recovery (Colonial at 4-5; Fall River Reply at 3).

While pooling accounting does not result in an acquisition premium, Bay State and Boston Gas/EE contend that shareholders would still face the risk of earnings dilution if the earnings per share of the combined entity is less than that of the acquiring company (Bay State at 4-5; Boston Gas/EE at 37-39). As a proposed remedy, Bay State proposes that those mergers using this accounting treatment should provide for a percentage of the savings to be shared between shareholders and ratepayers (Bay State at 5). Boston Gas/EE proposes that recovery of the earnings dilution ("economic premium") be reflected in rates (Boston Gas/EE at 37-39).

Commenters supporting recovery of acquisition premiums all agree that such recovery should be allowed only to the extent that demonstrated or projected cost savings accrue from

the merger (Bay State at 6; Berkshire at 8-9; Colonial at 4-5; COM/Energy at 38, 127-128; DOER at 21; Fall River at 8; Milford Reply at 2; WMECo at 2).

2. Recoverable Level of Acquisition Premiums

Commenters who advocate recovery of acquisition premiums disagree on the definition to be applied. Some commenters advocate the adoption of a premium based on the difference between the purchase price and book value ("book premium") at the time of the acquisition as the basis for the premium (Bay State at 7, 15; Boston Gas/EE 5/16/94 Comments at 6; Colonial 5/16/94 Comments at 4-6; Mass-American/Salisbury 5/16/94 Comments at 1; WMECo at 2). Other commenters propose that the difference between the purchase price and market value of the company proposed to be acquired at some point in time prior to the announcement of a merger agreement ("control premium") provides the best measure of recoverable merger costs (Berkshire at 7-8, 5/16/94 Comments at 3-4; BECo 5/16/94 Comments at 2; COM/Energy at 129; Essex 5/16/94 Comments at 4-5; Fall River 5/16/94 Comments at 2-3; MECo at 14).[10] While citing their opposition to any recovery of acquisition premiums, Essex and the Unions note that if the Department finds it necessary to define the acquisition premium, the premium should be limited to the control premium (Essex 5/16/94 Comments at 4-5; Unions 5/16/94 Comments at 2). WMECo claims that there is no difference between the use of the book premium and the control premium.

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[10] Bay State notes that in pooling accounting, the critical factor for shareholders is earnings dilution. In mergers based on pooling accounting, Bay State proposes that recovery be limited to the earnings dilution, which would be approximately equal to the control premium resulting through traditional accounting (Bay State 5/16/94 Comments, Question No. 2 at 1-2).

WMECo reasons that because the purchase price would by its nature represent market price, there should be no debate between the merits of either approach (WMECo 5/16/94 Comments, Question 2 at 1).

In addition to the actual purchase price paid for the utility assets, there are other costs associated with a merger. By way of illustration, these associated costs include regulatory expenses, financing costs, and expenses associated with workforce revisions. A number of commenters proposed that the components of an acquisition premium also include the direct and indirect costs associated with merger or acquisition activity. Some of the costs proposed for consideration include transaction and regulatory expenses (Bay State at 7, 16; BECo at 6; Boston Gas/EE at 34-36; Colonial at 14; COM/Energy Reply at 13; DOER at 21; MECo at 14; Milford Reply at 2), return on unamortized balances (Bay State at 7), income tax effects intended to make shareholders whole (Bay State at 7), expenses associated with reductions in workforce or elimination of surplus facilities (MECo at 14), and refinancing costs (Boston Gas/EE at 34-36). DOER also recommends that the premium include all changes to capital costs and capital structure that arise from the merger (DOER at 21).

Several commenters propose that a combination of the two definitions of premium be used. While endorsing the use of the difference between purchase and book in those mergers that rely on purchase accounting, Colonial asserts that the control premium should represent the minimum level of recovery, and that the allocation of additional benefits between shareholders and customers should be established on a case-by-case basis (Colonial 5/16/94 Comments at 4-6). DOER offers three different measures, whose application would depend upon the individual circumstances. If the purchase price for the acquired utility is greater

than both market and book value, and the market price is greater than book value, DOER recommends that the control premium be considered the appropriate level of recoverable premium (DOER 5/16/94 Comments at 5). If, on the other hand, the purchase price is greater than market price or book value, and the market value is less than book, DOER recommends that the premium should represent the difference between the purchase price and book value (id.). In all other cases, as when the purchase price is less than book, DOER concludes that the premium should be set at zero in the absence of special circumstances (id.).

Regarding the use of pooling of interests accounting to record mergers, DOER states that generally accepted accounting principles will dictate whether a proposed merger would be classified a pooling-of-interests or a purchase (DOER Reply at 8). Therefore, DOER does not believe it is necessary for the Department to endorse as part of this proceeding the use of either purchase accounting or pooling accounting (id. at 8-9). In those cases where pooling accounting is used, DOER suggests that the Department consider the appropriateness of recovering the economic premium defined by Boston Gas and Bay State through rates on a case-by-case basis (id. at 9-10).

Turning to the issue of the mechanics of recovery, the commenters offered several methods through which an acquisition premium could be recovered. According to BECo, COM/Energy, DOER, MECo, and WMECo, the acquisition premium should be included in rate base, amortized over a period of time, and both the annual amortization and return on the unamortized balance be included in cost of service (BECo at 5-6; COM/Energy at 126-127; DOER at 22-23; MECo at 14; WMECo at 2). Colonial proposes that the

premium should be amortized over the period during which cost savings are anticipated, with the unamortized balance included in rate base (Colonial at 15). ComEnergy advocates amortizing the premiums against any merger benefits that have been demonstrated to have occurred in subsequent rate cases (COM/Energy at 126-127). DOER proposes that the amortization period be based on the term of the debt used to leverage the acquisition, and WMECo suggests that the amortization be based on the weighted average of the remaining book life of the acquired company's assets (DOER at 22-23; WMECo at 2).

C. Analysis and Findings

The Department has noted its interest in issues of cost savings by utility companies, and fully expects all utilities to explore any and all measures that provide the opportunity for these savings. Cambridge Electric Light Company, D.P.U. 92-250, at 6-7 (1993). We view mergers or acquisitions as a useful and potentially beneficial mechanism for utility companies to consider in meeting their service obligations.

Where the potential benefits for customers exist, it would not be in their interests to maintain a per se barrier against mergers. If it can be demonstrated that denying recovery of an acquisition premium prevents consummation of a particular merger that would otherwise serve the public interest, then we may be willing to allow recovery of an acquisition premium. Therefore, we will no longer follow the practice of denying acquisition premium recovery on a per se basis.

On the other hand, the Department will not automatically allow recovery of all premiums associated with each and every merger. Rather, we are requiring parties to demonstrate that the recovery of acquisition premiums is allowable as part of the general

reckoning of cost and benefit under the G.L. c. 164, § 96 consistency standard. Adoption of a presumptive rule in favor of acquisition premiums might mislead shareholders to expect guaranteed recovery of merger-related costs, regardless of the existence of countervailing advantages. Moreover, a blanket policy favoring recovery of acquisition premiums might have the unintended consequence of preventing market forces from acting as a restraint against what may otherwise be considered unwarranted premium levels. Therefore, based on the foregoing, the Department finds that in the future it will on a case-by-case basis consider individual merger or acquisition proposals that seek recovery of an acquisition premium. Additionally, the Department will consider the appropriate level of a recoverable acquisition premium on a case-by-basis.

IV. OTHER ISSUES

A. Performance-Based Regulation

Utilities must address the question of the merits of mergers and acquisitions as part of their general obligation to provide safe and reliable service of the lowest possible cost to society. In addition to merger opportunities, the Department has also taken note of other critical elements of regulation that are currently undergoing change. The current proceedings regarding NYNEX's incentive ratemaking proposal in D.P.U. 94-50 and Bay State Gas' interruptible transportation service in D.P.U. 93-141, as well as our decisions concerning economic incentives in Boston Gas Company, D.P.U. 92-259 (1993) and economic development rates in Commonwealth Electric Company, D.P.U. 93-41 (1993), are examples of efforts undertaken by the Department to provide more opportunities for utilities to meet their obligations to their customers.

Several commenters in this case have argued that the existing regulatory framework neither adequately rewards efficient management nor adequately penalizes inefficient management (Colonial at 2). In other words, these commenters maintain, it makes too little difference if the company meets its goals or not.

Several commenters have suggested the Department explore an entirely new regulatory framework. Colonial recommends that the Department conduct an investigation of alternatives to the present regulatory system (Colonial at 2-3). Colonial asserts that the focus should not be on rate recovery of the costs of mergers or acquisitions or on any other individual regulatory rule. (id.). Instead, Colonial advocates that the Department reexamine the entire current system of utility regulation (id.). According to Colonial, the broader issue is whether the current regulatory system is best designed in a rapidly changing environment to promote achievement of the Department's fundamental goals (id. at 17). Colonial holds that the changes in the electric and gas industries have rendered traditional rate of return regulation obsolete so that it is no longer the best mechanism for ensuring that companies maximize ratepayer benefits (id. at 2-3, 17). According to Colonial, alternative approaches might involve various types of penalties and incentives, indexed mechanisms (e.g., cost adjustment mechanisms or price caps), sharing mechanisms (e.g., sharing savings or partial cost recovery mechanisms), or rate of return adjustments (id. at 3).

North Attleboro also recommends that the Department explore an entirely new regulatory framework (North Attleboro Reply at 3). According to North Attleboro, a performance-based regulatory framework would encourage utilities to take actions which will maximize benefits to customers because under such a system, shareholder and ratepayer

interests would be more closely aligned than ever before (id. at 2). North Attleboro asserts that such a regulatory framework would neither encourage nor discourage consolidation or any other specific action by utilities, and would reward good performance and penalize poor performance (id.).

The Department recognizes the potential of alternative regulatory mechanisms to improve the performance of regulated companies in its jurisdiction in all areas. We are prepared to give serious consideration to such alternative approaches. In fact, a proposal from New England Telephone and Telegraph Company, d/b/a NYNEX, for such alternative regulatory treatment is currently under consideration in D.P.U. 94-50. With respect to other regulated industries, the Department believes it worth investigating whether significant benefits could accrue to customers if a performance-based regulatory process were developed. The Department is firmly committed to moving towards a more competitive market as a means to achieve our regulatory goals. Performance-based regulation may well be an appropriate framework in which to achieve these goals on an interim basis before competition's potential is fully realized. Accordingly, the Department will in September 1994 issue a Notice of Inquiry ("NOI") into performance-based regulation of regulated industries. Issuance of an NOI should encourage regulated companies to advance their own proposals for alternative regulatory procedures.

B. Acquisition Defense Mechanisms

One of the issues raised by the Department concerned the appropriateness of utilities adopting merger or acquisition defense mechanisms such as "poison pills" and protective stockholders rights plans. Commenters indicated that the issuance of stock under

stockholders rights plans is permitted under G.L. c. 164, §14, and that the Department should review each petition involving such plans on a case-by-case basis, balancing the interests of customers and investors (Attorney General 5/16/Comments at 5; Bay State 5/16/Comments at 1; BECo 5/16/Comments at 2; COM/Energy 5/16/Comments at 7; Essex 5/16/Comments at 8; MECo 5/16/Comments at 4-5; Mass-American Water/Salisbury 5/16/Comments at 1; WMECo 5/16/Comments at 1). Further, some commenters stated that stockholders rights plans have been recognized as a valid device by the courts and have been authorized by legislation under G.L. c. 156B, § 32A (Bay State 5/16/Comments at 1; COM/Energy 5/16/Comments at 7; Colonial 5/16/Comments at 9; Essex 5/16/Comments at 7-8).

Finally, commenters claimed that in general, stockholders rights plans are adopted to prevent abusive and speculative takeovers and should not be viewed by the Department as impediments to mergers or acquisitions (Bay State 5/16/Comments at 1-3; BECo 5/16/Comments at 2; Boston Gas/EE 5/16/Comments at 10; Colonial 5/16/Comments at 7-9; COM/Energy 5/16/Comments at 7-8; Essex 5/16/Comments at 7; Fall River 5/16/Comments at 5-6; MECo 5/16/Comments at 5; Mass-American Water/Salisbury 5/16/Comments at 2).

In Bay State Gas Company, D.P.U. 90-40 (1990), the Department approved the issuance of stock in connection with a shareholder rights plan that would be triggered by certain take-over activities. In approving the shareholder rights plan in that case, the Department found that the issuance and sale of stock was reasonably necessary and further that the plan was likely to serve its purpose of discouraging a hostile takeover and appropriate in the regulated utility context. Id. at 9-11. The Department further noted that

by discouraging certain takeover tactics, a shareholder rights plan could lead to greater management stability and continuity which in turn might help to assure dependable and efficient service. Id. at 11. Nevertheless, we serve notice that these kinds of provisions are not to be adopted simply in order to entrench an unresponsive or inefficient management and to insulate it from market forces in the emergent competitive environment. The Department will continue to review and evaluate petitions for approval of stockholders rights plans on a case-by-basis, in order to assure itself that such plans are clearly necessary to the utility's obligation to provide service to the public. The Department will also continue to determine whether any action taken by utilities, such as poison pill protections, would diminish the companies' obligation to provide safe, reliable, low-cost service to customers.

V. ORDER

Accordingly, after due notice and consideration, it is hereby

ORDERED: That future merger and acquisition proposals shall be reviewed in a manner consistent with this Order.

By Order of the Department,

_____
Kenneth Gordon, Chairman

_____
Barbara Kates-Garnick, Commissioner

_____
Mary Clark Webster, Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).